Client Alert

July 10, 2013

Goldilocks, Porridge and General Solicitation

Introduction

At long last, the U.S. Securities and Exchange Commission (SEC) took action today to implement rules that complied with the JOBS Act mandate to relax the prohibition against general solicitation in certain private offerings of securities. The original SEC proposal from August 2012, proposing amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act, had drawn significant comments. Today's final rule, as well as the SEC's proposed rules relating to private offerings discussed below, are likely to generate additional commentary. One might say that this morning's webcast of the SEC's open meeting provided a glimpse into the too-hot/too-cold Goldilocks-type debate that will continue to play out over the next few months regarding the appropriate balance between measures that facilitate capital formation and investor protection provisions.

In addition to promulgating rules to relax the ban on general solicitation, which will have a significant market impact, the SEC also adopted the bad actor provisions for Rule 506 offerings that it was required to implement pursuant to the Dodd-Frank Act. The bad actor proposal had been released in 2011, and SEC action had been anticipated on the bad actor proposal for some time. The SEC also approved a series of proposals relating to private offerings that are intended to safeguard investors in the new world of general advertising and general solicitation. All told, will these measures encourage or discourage issuers and their financial intermediaries from availing themselves of the opportunity to use general solicitation? Will this new ability to reach investors with whom neither the issuer nor its intermediary have a pre-existing relationship create serious investor protection concerns? Will the proposed investor protection measures be sufficient to address the concerns of consumer and investor advocacy groups, or will we ultimately see revamped investor accreditation standards?

Below we provide a very brief summary of this morning's actions. We will supplement this alert with more detailed analysis and commentary once the final rules and the proposal are released.

SEC Adopts Amendments to Rule 506

This morning, the SEC adopted amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act to implement Section 201(a) of the JOBS Act. The SEC adopted new paragraph (c) in Rule 506, which would permit the use of general solicitation and general advertising, subject to the following conditions:

- the issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;

- all purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and

- the conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied.

The Staff indicated that "reasonable efforts" to verify investor status will be an objective determination by the issuer based on the SEC's principles-based guidance. In its proposed rules, the SEC had noted that "reasonable efforts" to verify investor status should consider the nature of the purchaser; the nature and amount of information about the purchaser; and the nature of the offering. In a departure from the proposed rules, the final rule will provide a non-exclusive list of factors to consider in verifying the accredited investor status of natural persons. Following the initial proposal, many commenters had advocated that a "safe harbor" be established to establish legal certainty that the verification process had been sufficiently robust. Including this illustrative list as part of the rule will likely prove helpful, even if it does not go as far as some commenters had requested.

In addition to the changes adopted to Rule 506, the SEC amended Rule 144A to eliminate references to "offer" and "offeree," and as a result Rule 144A will require only that the securities are sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB. Under this amendment, resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are limited in this manner.

Commissioner Luis Aguilar strongly opposed the new rules, saying he was "saddened and disappointed" that the new rules did not do more to protect investors.

Bad Actor Rule Proposal

In the same meeting, the SEC explained that it was adopting the bad actor rule in substantially the form in which it was proposed in May 2011 with certain modifications. The Staff explained that the rule contains modifications to the categories of persons covered; modifications to the types of actions that are covered; and modifications to the actions that are covered. In addressing the modifications to the categories of "covered persons," the Staff explained that, in certain respects, the categories were being narrowed. For example, the Staff noted that, as opposed to covering all officers of the issuer, the rule will cover executive officers and officers involved with the proposed offering. The rule will cover beneficial owners of 20% or more of an issuer's total shares outstanding. The Staff noted that investment managers of funds and the principals of such investment managers will be added as covered persons. The Staff noted that the types of actions covered in the final rule ("disqualifying events") have been modified from the proposal in order to include certain SEC cease-and-desist orders related to violations of anti-fraud provisions and registration requirements, and to add the CFTC to the list of agencies whose final orders trigger the application of the bad actor rules. The rule also will address one of the most controversial provisions of the proposal, which is the timing of an action that triggers the application of the bad actor provisions. The rule will provide for disqualification only in respect of triggering bad acts that occurred after the effective date of the rule, however, triggering events that occurred prior to the effective date of the rules will need to be disclosed to investors.

Investor Protection and Information Requirements Proposed

The SEC is proposing rules for comment that will impose a number of investor protection measures in connection with Rule 506(c) offerings. These include the following: A proposed amendment to Rule 503 in order to implement additional compliance requirements relating to the filing of a Form D. In connection with a Rule 506(c) offering, an issuer will be required to file a Form D not later than 15 calendar days from the commencement of general solicitation efforts. In addition, in order to provide the SEC with more information regarding these types of offerings, the issuer will be required to file a final amendment to the Form D within 30

days after the completion of such an offering. Along the same lines, in order to make additional information available to the SEC, the proposal would revise Form D in order to request additional information in the context of Rule 506(c) offerings. For example, the amended Form would require additional information about the issuer, the offered securities, the use of proceeds of the offering, the types of general solicitation that were used, and the methods used to verify investor status. The Staff also proposes an amendment to Rule 507 in order to promote compliance with the Form D filing requirement by implementing certain disqualification provisions to the extent that the issuer and its affiliates failed to comply with Form D filing requirements. The SEC would have the authority to grant waivers upon a showing of good cause by the issuer. The proposal also would include the introduction of a new Rule 509. Proposed Rule 509 would require an issuer engaging in a Rule 506(c) offering to include certain legends on any written general solicitation materials. The required legends would alert potential investors of the type of offering, that the offering is available only to certain investors, and that the offering may involve certain risks. The proposal also would require that for a temporary period of two years, issuers be required to file with the SEC any written solicitation materials. These materials would not be available to the public. This is intended to permit the SEC to review the types of materials that are being used. The proposal also solicits comment on the definition of "accredited investor" and requests comment on whether there should be additional requirements relating to the communications used in general solicitation.

Rule 156 Proposal

The SEC proposed to require private funds making Rule 506(c) offerings to file written general solicitation materials with the SEC on a temporary basis. The filings would be required to apply for a period of two years, and would not be available to the public. The SEC also proposed to amend Rule 156 under the Securities Act of 1933, the anti-fraud rule that applies to sales literature of registered investment companies. The rule amendments would apply the guidance to sales literature of private funds making general solicitations under Rule 506.

Rule 156 prevents registered investment companies from using sales literature that is materially misleading in connection with the offer and sale of securities. The rule provides that sales literature is considered misleading if it (i) contains an untrue statement of a material fact; or (ii) it omits to state a material fact necessary in order to make a statement, in light of the circumstances of its use, not misleading.

Rule 156 provides specific examples of regarding the types of statements in sales literature that the SEC would consider to be misleading. Generally, whether a statement involving a material fact would be misleading depends on the context in which it is made, in light of all pertinent factors, including:

- Other statements being made in connection with the offer or sale of the securities in question;
- The absence of explanations, qualifications limitations or other statements necessary or appropriate to make the statement not misleading; or
- General economic or financial conditions or circumstances.

Rule 156 provides a non-exclusive list of factors concerning representations of past or future investment performance that could be misleading. It also contains examples of when statements about possible benefits connected with or resulting from the services to be provided that do not give equal prominence to discussion of any associated risks.

Rule 156 broadly defines "sales literature," which generally means any communication (whether in writing, by radio or by television) used to sell or induce the sale of securities of any investment company. Communications between issuers, underwriters and dealers are included in this definition of sales literature if the communication (or the information it contains) can be "reasonably expected" to be communicated to prospective investors in the

offer or sale of securities, or are designed to be employed either in written or oral form in the offer or sale of securities, such as in sales scripts. The definition likely would apply to communications contained in social media.

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